subscribers.[70] The unamortized acquisition premiums as of the end of 1992 for 22 large, publicly held cable companies (representing 31 million subscribers or approximately 55% of total nationwide cable subscribers) are estimated to total $11 billion. This amount equals almost 60% of these companies' capital.[71] Based on these companies, total cable industry acquisition premiums are estimated to be $17 - $20 billion.

This consolidation of the cable television industry has been in the public interest. The development of large, multifranchise operating units has reduced operating costs, allowed for better service, and permitted the growth of advertising sales. Equally important, it has led to large MSOs that were able to obtain major programming cost discounts by guaranteeing large numbers of subscribers to programming services. During the development of the telephone and electric power systems, a consolidation period was essential for the creation of the modern systems we now enjoy.

These capitalized intangible asset values are a significant factor affecting the financial structure of the industry. A regulatory system that does not allow recovery of the cable industry's acquisition premiums will have a significant and materially adverse impact on the industry, its financial structure, its ability to attract capital, and the reasonableness of the returns granted to the investors who invested in these

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[70] Cable TV Investor Newsletter, January 25, 1993, Page 12.

[71] See Table 2 appended hereto as Attachment "B".

acquiring companies. CCTA believes that the Commission must squarely address the problem of acquisition premiums from a financial point of view. Failure to do so will result in confiscatory rates.

However, the Commission seems to be inclined toward traditional regulatory policy in this regard:

> Traditionally, excess acquisition costs have been excluded from the ratebase of regulated concerns, at least in part, because they are seen as inappropriate costs for the ratepayer to bear. This is because the premiums from excess acquisition costs directly benefit the seller, not the ratepayer, since they do not contribute to the plant supporting service to consumers. We note that subscribers may benefit indirectly from the sale if the purchaser is able to realize operating efficiencies that are unobtainable by the seller, but this is not likely to be the case where competition does not exist, since premiums may reflect an expectation of monopoly earnings. Generally, where competition does not exist, the presumption is that premiums reflect an expectation of monopoly earnings.[72]

CCTA believes that imposition of traditional COS rules on cable television companies is constitutionally inappropriate. Traditional utilities have been "on notice" that, in general, acquisition premiums would not be allowed in rate base. In contrast, before the 1992 Act there were no expected prohibitions against the recovery of cable acquisition premiums. Further, the 1984 Cable Act deregulated the cable television industry precisely to permit its expansion, one of the consequences of which was industry consolidation. To import regulatory standards from mature utilities that have been subject to traditional COS regulation for almost fifty years and apply these regulatory

[72] NPRM, ¶ 36.

principles to the cable industry, which has matured in a deregulated rate environment for six years (realizing during these six years its most significant growth in terms of subscribers and the services offered) is ludicrous.

The cable industry is now regulated. To the extent that companies merged and became more efficient, under COS the ratepayers benefit because these efficiencies are reflected in lower rates. Thus, to penalize the more efficient companies now for undertaking acquisitions in the deregulated rate environment that produced these efficiencies is not sound policy and is based on indefensible economics. Finally, the Commission noted that the "premiums may reflect an expectation of monopoly earnings."[73] They may, but then again, they may not. The Commission needs to study this question carefully. Acquisition premiums are paid every day for many businesses that are in competitive markets. Such premiums are paid for the entertainment and information competitors of cable television. In fact, the great majority of acquisitions include an acquisition premium. This is particularly true in industries such as computer software and technology which are clearly very competitive. Thus, the payment of an acquisition premium is not by itself a reflection of monopoly power.

The Commission must squarely examine the potential impact of its regulations on the cable television industry. COS will seriously constrain the cable television operators from

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[73] Id. Emphasis added.

recovering acquisition premiums. Exclusion of such premiums could result in confiscatory financial losses.

CCTA therefore concludes that the Commission's analysis and basis for rejecting the inclusion of acquisition premiums are lacking and flawed. The failure to deal adequately with the reality of the acquisition premiums will result in consequences contrary to the intent of the Cable Act because it will paralyze the ability of cable companies to develop and expand their plant and to compete. Also, contrary to the Constitution, it will shut off access to the capital markets and produce confiscatory rates.

3. The FCC Rules Must Take into Consideration the Unique Aspects of Cable Television Intangible Assets and Include Their Total Value in Rate Base.

The Commission has tentatively concluded that "excess acquisition costs," including the value of customer lists, franchise rights, goodwill, and other intangible assets should be excluded from the ratebase.[74] The Commission bases its conclusion on the notion that 100% of the price paid for a cable system over the value of the tangible assets reflects the expectancy of monopoly earnings, and as such they are inappropriate costs for the consumer to bear since they do not contribute to the plant supporting service. The Commission's conclusion is flawed because it fails to recognize the vital role that intangible assets play in providing cable television service. For this reason, these assets can have substantial

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[74] Id., ¶ 40.

value regardless of whether the cable operator enjoys a monopoly market position.

a. "Intangible Assets" in General

Before addressing cable television intangible assets specifically, it is necessary to establish what an intangible asset is. The following definitions are helpful in this regard:

- Assets: "... probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[75]
- Assets: "Economic resources which are owned by a business and are expected to benefit future operations. Assets may have definite physical form such as buildings, machinery, or merchandise. On the other hand, some assets exist not in physical or tangible form, but in the form of valuable legal claims or rights."[76]
- Business assets: "Tangible and intangible resources other than personal property and real estate that are employed by a business enterprise in its operation."[77]

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[75] *Statement of Accounting Concepts No. 6*, Financial Accounting Standards Board, 1985.

[76] Walter Meigs, Charles Johnson, Robert Meigs, *Accounting, The Basis for Business Decisions*, Fourth Edition, 1977.

[77] American Institute of Real Estate Appraisers, *Uniforms Standards of Professional Practice*, 1990.

- Intangible assets: "Assets which are used in the operation of the business but have no physical substance, and are noncurrent."[78]
- Intangible assets: " ... all the elements of a business enterprise that exist after monetary and tangible assets are identified."[79]

These definitions establish that the intangible assets of a cable television system are those nonphysical resources employed in the operation of the business that alone or in combination are expected to benefit future operations.

The Accounting Principles Board of the American Society of Independent Public Accountants, in prescribing rules for the accounting of intangible assets, has recognized that these assets have no prerequisites with regard to origin, life, or relationship to the business enterprise other than those addressed in the above definition. Specifically, the Board states its opinion[80] on identifiability,[81] manner of

[78] Walter Meigs, Charles Johnson, Robert Meigs, *Accounting, The Basis for Business Decisions*, Fourth Edition, 1977.

[79] Gordon Smith, Russell Parr, *Valuation of Intellectual Property and Intangible Assets*, 1989.

[80] Accounting Principles Board, American Institute of Certified Public Accountants, *APB Opinion No. 17, Intangible Assets*.

[81] Intangible assets may be separately identifiable or lack specific identification: "Many kinds of intangibles may be identified and given reasonably descriptive names, for example, patents, franchises, trademarks, and the like. Other types of intangible assets lack specific identifiability . . . The excess of the cost of an acquired company over the sum of identifiable net assets, usually called goodwill, is the most common unidentifiable intangible asset."

acquisition,[82] expected period of benefit,[83] and separability from an entire enterprise.[84]

A review of the pronouncements of the above authorities indicates that only three criteria must be met to qualify as an intangible asset, namely, the resource must be (1) nonphysical (i.e., unable to be perceived by the senses); (2) employed in the operation of the business in question; and (3) expected to produce higher earnings for the business than would be expected without it.

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[82] Intangible assets can be acquired singly, in groups, or in business combinations or developed internally: "An enterprise may acquire intangible assets from others or may develop them itself . . . Both identifiable and unidentifiable assets may be developed internally. Identifiable intangible assets may be acquired singly, as part of a group of assets, or as part of an entire enterprise, but unidentifiable assets cannot be acquired singly."

[83] Intangible assets can have lives which are limited by law or contract, related to human or economic factors, or of indefinite or indeterminant duration: "Intangible assets have been divided into two classes for purposes of accounting for their costs: (a) those with a determinable term of existence because it is limited by law, regulation, or agreement, or the nature of the asset, and (b) those having no limited term of existence and no indication of limited life at the time of acquisition."

[84] Intangible assets can consist of rights which are either transferable without sale, salable, or inseparable from the enterprise or a substantial part of it: "Ordinarily goodwill and similar intangible assets cannot be disposed of apart from the enterprise as a whole. However, a large segment or group of assets of an acquired company or the entire acquired company may be sold or otherwise liquidated, and all or a portion of the unamortized cost of the goodwill recognized in the acquisition should be included in the cost of the assets sold."

b. Accounting and Income Tax Treatment of Intangible Assets.

The elusive nature of many intangible assets has led to misunderstanding and disagreement over the proper accounting for, valuation of, and tax treatment of intangibles. Many of the disputes have a long history. With the explosion of mergers and acquisitions during the late 1980s, however, the dollars at stake increased substantially. During this period, cable system operators and investors paid billions of dollars for the intangible assets of the cable systems they acquired causing their corporate balance sheets to swell with the value of intangible assets, sometimes to the point where their value exceeded the value of the tangible assets. Generally accepted accounting principles (GAAP) prescribe two different methods for accounting for intangibles depending on their origin.[85] GAAP also provide specific criteria that must if asset is to be carried separately on a cable system's balance sheet.[86] The

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[85] "In general, when intangibles are purchased from others, they are recorded at purchase cost. Cost of developing specific intangibles such as patents are capitalized, but only out-of-pocket items such as legal fees and application and filing fees are included. The more basic cost of development, which are akin to research and development, are expensed as incurred. Of course, self-developed intangibles that are not specifically identifiable and are inherent in a continuing business as a whole are not capitalized." Robert S. Kay, CPA, D. Gerald Searfoss, DBA, CPA, eds. Handbook of Accounting and Auditing, Second Edition, Warren, Gorham & Lamont, New York, 1989, 15-36.

[86] 1. It must be identifiable or be able to be called by a name that is commonly recognizable; 2.It must have a statutory or contractual useful life; and 3.It must be individually transferrable and be separable from the business. Gordon Smith, Russell Parr, Valuation of Intellectual Property and Intangible

failure to met these criteria does not, however, mean that the intangible asset does not exist, only that it must be grouped with other such assets under a label such as "other intangibles" or "goodwill."

GAAP also recognize that all acquired intangible assets decrease in value over time. Thus, the value of all intangible assets carried on the balance sheet, including the value of the myriad of unidentified intangibles recorded under the label "other intangibles" or "goodwill," are to be amortized over their estimated remaining useful life which is not to exceed 40 years.

Federal income tax rules are consistent with GAAP in requiring that all acquired intangible assets be recorded on the balance sheet at their fair market value at the time of acquisition. Until recently, however, only intangible assets that can be separately identified and valued and that have determinable, useful lives qualify:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to an allowance for depreciation ... No deduction for depreciation is allowable with respect to goodwill ... [87]

With the passage of the 1993 budget bill, however, cable system operators can now amortize the value of all intangible

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Assets, John Wiley & Sons, 1989).

[87] Internal Revenue Code, Section 167(a)-3.

assets acquired after July 25, 1991, including the value of subscriber lists, franchises, and goodwill, over 15 years.[88]

The billions of dollars paid for cable system intangible assets has provided incentive for appraisers to draw on financial, economic, and valuation theory to develop new techniques for (1) identifying intangible assets, (2) estimating their remaining lives, and (3) quantifying the expected benefits to be derived from them.

c. The Expectations of Investors in Cable Television Systems and Intangible Assets.

Two cable systems that possess equally valuable intangible assets could have markedly different balance sheets. In one case, a system may make a substantial investment in developing such intangibles as a highly skilled workforce, customer lists, specialized computer software, marketing agreements, etc. These assets may have a substantial impact on sales and earnings and may, therefore, be valuable. However, because they were developed internally, this value does not appear on the system's balance sheet. In the second case, the assets of a cable system with similar valuable intangibles is acquired by an investor. GAAP requires that the intangible assets be recorded on the system's balance sheet at their appraised value at the time of acquisition. This capitalization of existing but previously unrecorded value explains, in part, the dramatic increase in the

[88] The Omnibus Budget Reconciliation Act of 1993, 1993 HR 2264.

reported intangible asset values of cable television systems during the last decade.

CABLE SYSTEM BALANCE SHEET AS IT APPEARS TO AN INVESTOR

Current assets	Current liabilities
Tangible assets	Long-term debt
Other assets	Equity
Intangible assets	

In the real world investors seldom take a bottom-up approach to valuing a cable system (i.e., they seldom sum the values of the individual assets to arrive at the value of the total business enterprise). Rather, the typical approach is top down, where a value conclusion is reached based on the earnings or cash flow the system is expected to generate. This "holistic" approach to valuation assumes that all of the tangible and intangible assets necessary to operate at the projected level are in place. This being said, however, investors do evaluate the tangible and intangible assets of a cable system. Cash flow projections, for example, usually incorporate the cost of upgrading or replacing outmoded plant and equipment. Likewise, the quality of intangible assets, such as skilled workforce, subscriber relationships, etc., is reflected either explicitly in the cash flow projections or implicitly in the assessment of the risk in achieving the projections.

The Fifth Amendment and Hope require that the Commission take intangible assets into account when developing regulations.

d. Intangible Assets of Cable Television Systems.

As previously discussed, three criteria must be met for designation as an intangible asset: the asset in question must be nonphysical, employed in the operation a the cable system, and expected to increase the earnings of the system over what they would be without the asset. It is also true that intangible assets may or may not be separately identifiable. The aggregate value of the intangibles acquired through purchase that are not separately identifiable are carried on the balance sheet under a category such as "other intangibles" or "goodwill."

Based on a review of the operations of cable systems and using the criteria noted above, the following are examples of intangible assets that may be employed in a cable television system: rights (e.g., operating rights,[89] advertising interconnect agreements,[90] programming contracts,[91] licenses,[92]

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[89] Cable systems generally operate under the authority of franchise/license agreements. The rights granted by these agreements are nonphysical. Possession of the operating rights granted by these agreements is essential to the provision of cable services. Without authority to provide service, a cable system would have no earnings.

[90] Advertising interconnect agreements are contractual arrangement among cable systems pertaining to the production and distribution of local advertising. The rights granted under this agreement are nonphysical. Sale of local advertising time is part of a cable television business. Interconnect agreements allow advertisers to reach substantially more subscribers for less cost than would be possible by buying time on individual cable systems. This feature could be expected to result in greater

and access agreements),[93] intellectual property (e.g., management

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advertising sales revenue and earnings for members of the interconnect than would be expected without participation.

[91] Cable television operators enter into separate contracts with cable networks for the right to distribute the network's programming. The rights granted under these contracts are nonphysical. Possession of these contracts is a prerequisite to providing a substantial portion of the programming offered by a cable system. Without these contracts, the programming delivered by a cable system would be limited primarily to off-air television signals, most of which could be received directly by the subscriber. Without the authority to deliver a selection of cable-exclusive programming, it is reasonable to expect that the system would suffer a substantial decline in subscribers, revenues, and earnings.

[92] As part of its headend, distribution, and technical service operation, a cable system may use satellite, microwave and radio reception and transmission systems which require licensing by the FCC. The rights granted by these license are nonphysical. Some of these licenses are essential to the provision of cable television service. Others are required as part of the system's operating procedures. Since possession of some of these licenses is a prerequisite to providing cable service, the system would have no earnings without them. The possession of others enables the system to operate more efficiently, resulting in lower expenses and higher earnings than would be expected otherwise.

[93] Cable systems often negotiate numerous agreements with owners of multiple dwelling units, e.g., apartment buildings, hospitals, nursing homes, allowing it to install and operate cable television equipment on the premises. The rights granted by these agreements are nonphysical. These agreements are required in order to provide cable service within these privately owned facilities. Possession of these agreements allows the system to provide service to subscribers who could not be served otherwise, and to realize revenue and earnings that would not be possible without them.

and operating systems,[94] software,[95] and service marks,[96] relationships (e.g., assembled workforce,[97] and subscriber list.[98])

[94] The operations of cable systems are usually conducted in conformity with proprietary policies and procedures prescribing such things as system engineering and construction standards. The "ways of doing things" embodied in these policies and procedures are nonphysical. The cable system is operated, maintained and administered in accordance with these policies and procedures. These policies and procedures enable the system to function in an efficient, cost effective manner, thereby resulting in greater earnings than would be expected without them.

[95] Both internally developed and purchased computer software may be employed in the operation and administration of a cable system. The processes embodied in the code, program documentation, user instructions and operating manuals of this software are nonphysical. This software is utilized in the operation, maintenance and administration of the cable system. This software is intended to enable the system operate more efficiently and with fewer personnel than would be required without them, and are, therefore, expected to result in greater earnings than would be expected without them.

[96] The Trademark Act of 1946 defines "trademark" to include "any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured by others." While trademarks are used to identify goods, "service marks" are used to identify services, e.g., cable television service. The recognition and response associated with these service marks are nonphysical. The system's multicolored logo is usually emblazoned on its office, vehicles, masthead and monthly subscriber invoices. In addition, its service marks are featured prominently in various media in conjunction with numerous system-sponsored events and activities. They are also featured prominently in advertising aimed at existing and potential cable subscribers. The public recognition and positive feelings associated with a cable system's service marks can facilitate the marketing of cable television services and their existence is expected to result in more subscribers, higher revenues and higher earnings than would be expected if the system had no service marks or if it were to suddenly change its service marks.

[97] A cable system relies on an assembled workforce to provide service, including highly trained technical support and customer service personnel. It also maintains an ongoing program of employee training, evaluation, and recruitment. The relationship of the company to its workforce is nonphysical. The company's

The California legislature, after studying the role of intangible assets in a cable television system, concluded that intangible assets exist and that they may account for a significant portion of a system's value.[99]

In summary, cable television systems employ a myriad of intangible assets, some of which are a prerequisite to providing cable television service. Others intangibles, although not a prerequisite for service, have a significant impact on the provision of service. Unlike the situation at a utility, cable

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employees are essential to providing cable service. The existence of a full complement of trained employees could be expected to produce higher earnings than if the system had no employees.

[98] At the time of a sale, a cable system's current subscribers could be expected to remain with the system (and generate revenue) for a period of time determinable by historical data. The relationship of the company to its subscribers is nonphysical. The subscribers are transferred with the system at the time of a sale. Subscribers, as end users of the cable service, are an essential component of a cable system. The presence of a complement of subscribers who have an established relationship with the company which is likely to continue for some time could be expected to result in higher revenues and earnings than would be expected if the system had no subscribers in place.

[99] "SECTION 1. After investigation, the Legislature finds and declares as follows: (e) A significant portion of the fair market value of a cable television system may be attributable to intangible assets and rights in addition to the ownership of real and personal property. These intangible assets and rights may include, but are not limited to, franchises or license to construct, operate and maintain a cable television system for a specified franchise term (excepting therefrom that portion of the franchise or license which grants the possessory interest), subscriber contracts, marketing and programming contracts, nonreal property lease agreements, management and operating systems, a work force in place, going concern value, deferred, startup, or prematurity costs, covenants not to compete, and goodwill."

television operators face a discretionary market in which the resources employed in developing these intangibles can be expected to pay dividends in the form of higher earnings and higher returns than what they would have expected from the tangible assets alone.

While the value of these intangibles may be enhanced by lack of direct competition from another multichannel video provider, it is arbitrary and grossly incorrect to categorically attribute 100% of their value to the monopoly. The Commission should conduct further study to determine the value of the monopoly component, if any, -- either through examination of systems under effective competition or through other means -- to estimate the impact of these intangibles on value under competitive conditions. Because it lacks sufficient evidence on which to base a conclusion as to the value of the monopoly component, the Commission should allow COS standards that permit a cable television system an opportunity to establish a value for these intangible assets, net of any monopoly component, using accepted valuation theory. This value would be properly included in the ratebase and would be eligible for amortization as part of system expenses.

The Commission's regulations should also recognize the existence of valuable intangible assets even when such value has not been capitalized and carried on the system's balance sheet.

4. **The Commission's Recommended Level for Rate of Return Is Inadequate Given the Risks Inherent in Cable Television.**

The NPRM proposes "... a single rate of return for provision of regulated cable services by all cable operators...."[100]

To determine the ROR, the Commission noted that:

> We believe that the rate-of-return we select must be based on a careful analysis of the considerations that this agency, other regulators, and courts have employed in setting and reviewing rate-of-return for other industries subject to rate regulation. Accordingly, we proposed that the rate-of-return for regulated cable service shall be established, at least in part, by identifying the rate-of-return of a surrogate industry or activity, or of several industries or activities. We propose that this be accomplished by first choosing a surrogate that has comparable risk to that of the cable industry.[101]

The Commission has correctly identified some of the issues affecting the proper rate of return for cable companies:

> We also propose that we carefully consider the differences in the financial characteristics and capital structure of the surrogate or surrogates and the cable industry in determining the rate-of-return of regulated cable service. The cable industry differs from mature regulated industries like telephone, gas and electric, each of which is characterized by a steady return on investment. The cable industry is still a relatively new industry, characterized by growth and reinvestment of earnings with the possibility that the expectations of investors in the cable industry differ from other regulated industries. Moreover, the cable industry, unlike industries such as telephone, relies heavily on private and semi-public sources of capital.[102]

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[100] NPRM, ¶ 46.

[101] Id., ¶ 48 (footnote omitted).

[102] Id., ¶ 49 (footnote omitted).

The FCC's proposals fall short of providing for an adequate return because the cable television industry faces a higher level of risk than most regulated utilities. Therefore, the issue of rate of return cannot be separated from the particular investment and the remainder of the COS regulatory framework.

As noted above, regulated utilities face risks largely defined by the rate methodology employed by their regulators because regulated utilities "are virtually always public monopolies dealing in an essential service" and as such they are "relatively immune to the usual market risks."[103] However, cable television is not a monopoly, it competes with a wide variety of other entertainment and information providers,[104] and it has never been defined as an essential service. For these reasons, cable television is not immune to market risks. In fact, whereas monopoly utilities by their nature possess close to, if not, all the market for their particular service (e.g., telephone, gas, water, or garbage), the penetration rate for cable television is only slightly over 60% throughout the United States.[105] Stated another way, almost four in every ten households in America choose not to hook up to cable television. This fact increases

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[103] Duquesne Light Co. v. Barasch, 488 U.S. at 315. See Section I.B.4., supra.

[104] See Footnote 67, supra.

[105] Paul Kagan Associates, Inc., Kagan Cable TV Financial Data Book, June 1993.

the risk to cable television investors, as their investment is not protected by monopoly status.[106]

As noted above, Hope and its progeny require that the investors' interests be taken into account in setting rates to ensure that investors are fully compensated for the risks they have assumed.[107] Thus, CCTA believes that ultimately the Commission will require different RORs for differently situated companies and different investments. In particular, the Commission should investigate the authorization of a higher ROR for riskier investments. The Commission cannot determine the appropriate ROR in a vacuum. The ROR is one component of an overall regulatory system. As an example, to the extent that an alternative ratebase formula is allowed, the rate of return would have to be modified. Therefore, the Commission should determine the ROR as part of the overall regulatory system.

While the Commission has correctly noted some of the special characteristics of the cable industry, it has not adequately and fully investigated these characteristics and as a result does not and cannot fully understand how these characteristics will affect the ROR determination.

Two critical points need to be made with respect to ROR. First, cable television is unlike other regulated utilities.

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[106] The 1992 Cable Act does not permit franchise authorities to award cable monopolies in the form of exclusive franchises. 47 U.S.C. 541(a)(1). Most utilities operate under the legal umbrella of an exclusive franchise.

[107] New Jersey Power & Light, 1810 F.2d at 1177, citing Permian Basin Area Rate Cases, 390 U.S. at 792. See Section I.B., supra.

Therefore, an application of utility regulatory methodologies or the adoption of ROR determination from utility regulatory methods will not be applicable. The following table summarizes some of the differences:

COMPARISON OF RISKS

	Traditional Utility	Cable
Competitive Risks	■ Exclusive franchise ■ Limited competition for primary service ■ Service is a public necessity	■ Nonexclusive franchise • Broad competition with: - All entertainment products - Other video programming service providers ■ Service is optional. 40% of market doesn't subscribe
Technology Risk	■ Mature technology	■ New technologies make exiting assets obsolete
Financial Risk	■ Conservative capital structure, predictable dividend growth	■ Greater leverage
Willingness to take risk	■ Usually not without preapproval	■ Necessary to stay ahead of competition
Regulation	■ State or Federal level	■ Combined, local and FCC

Second, with respect to the adoption of a surrogate ROR such as one based on a portion of the S&P 400,[108] it is critical to note that the surrogate ROR is the actual ROR earned by the surrogate. The Commission proposes to use this ROR in its COS formula. The ROR will be used to determine the return which, when added to the cost, will produce the revenue requirement.

The surrogate return, however, is the actual return earned by the surrogate. This return is a "bottom line" return earned after deducting a variety of expenses including (1) amortization of acquisition premiums, (2) interest expenses associated with acquisitions, (3) R&D and other start-up expenses, and (4) write-offs for investment losses. If the Commission is going to adopt a surrogate return, then the proper application of this approach dictates that the Commission must determine the ROR in a consistent manner and provide that all of these expenses can be reflected in the rates of the companies. Failure to provide for this consistency would violate the Constitutional protection of the cable companies. Cable companies would not be earning a return commensurate with the risks if the surrogate ROR is determined after expense items that the cable companies are either not allowed or unable to include in their pricing. Further, CCTA believes that the cable industry is entitled to an ROR higher than that of the S&P 400, which includes many of this country's largest and most credit-worthy corporations. By

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[108] NPRM, ¶ 52.

contrast, few, if any, cable companies have debt which is rate "investment grade" or better by S&P.[109]

Thus, the Commission's approach to ROR is seriously flawed. The Commission must carefully consider the special nature of the cable industry in determining the appropriate ROR as part of its overall regulatory system because the Commission must be able to "articulate a reasoned explanation" for its choices and "draw a rational connection between the facts found and the choice made."[110] CCTA does not believe that the surrogate chosen by the FCC for rate of return can withstand this test.

CCTA recognizes that the determination of the ROR, indeed the determination of the entire regulatory system, requires the Commission to balance the interests of both consumers and operators. The Commission discussed this balancing in determining the rate of return:

> If the primary goal is ensuring that subscribers pay rates that are consistent with a competitive level, for example, we may select a relatively lower rate-of-return within the "zone of reasonableness" in which ratepayer interests are protected. Alternatively, if we want primarily to encourage reinvestment in infrastructure, we may select a relatively higher rate-of-return, with the zone of reasonableness.[111]

The Commission has properly recognized that its ROR determination will affect the level of reinvestment in infra-

[109] See, for example, Hidden Cable TV Financial Data Book, 78-79; Footnote 56, supra.

[110] Farmers Union, 734 F.2d at 1499. See Section IA, footnote 12, supra.

[111] NPRM, ¶ 47.

structure. Congress established as policy the goal in the 1992 Act that cable operators continue to expand where economically justified.[112] Further, consumers have an interest in this expansion of technology and infrastructure.[113] The Commission must not, therefore, err in thinking that the ROR and regulatory issues present simple issues of operator interests versus consumer interests. In fact, consumers have a great interest in the long-term viability and expansion of the cable television industry. Thus, these issues are tied up with the future of the telecommunications infrastructure and the long-term benefits that consumers will realize from the continued expansion of this infrastructure.

C. The Traditional COS Methodology Proposed by the FCC Will Result in Confiscatory Rates with an Overwhelming Adverse Impact on the Cable Industry.

The Commission has properly identified the requirements of the COS system:

> We believe that our regulatory requirements determining cost-based rates must reflect a balancing of the interests of cable operators and consumers that is fair and reasonable to both. Our requirements should permit cable operators to recover the reasonable costs of providing cable service and to attract capital, including the opportunity for reasonable earnings, while protecting consumers from paying inappropriate costs and unreasonable charges, which was one of Congress' primary concerns when effective competition for cable is not present.[114]

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[112] See 1992 Cable Act, Section 2(b)(3).

[113] See Section IV, infra.

[114] NPRM, ¶ 8 citing the Cable Act of 1992, Section 2(b)(4).

Given the broad problems discussed in the sections above, including: (1) the issues associated with the sustainablity of COS prices and the need for alternative COS formulations; (2) the acquisition premium is estimated to represent $17-$20 billion in assets for the industry; and (3) the inadequacies of the rate of return formulation. It is clear that the traditional COS system will not work for a large number of cable operators and will be confiscatory.

The constitutionality of a particular rate will be analyzed under Hope after the Commission or a franchise authority has set the rate under these rules. However, the success of the regulatory system can be determined to a certain extent by economic modeling. The FCC has much to do in this regard.[115] CCTA's analysis has shown that the system as proposed by the FCC will result in confiscatory rates for a number of companies.[116] The FCC must therefore adopt some combination of rate base, rate of return, and other policies to develop rules that will arrive at rates that fall within the zone of reasonableness.

D. The FCC Should Clarify Certain Key Issues Regarding the Application of the COS Methodology.

A large number of issues and details regarding the COS methodology and the relationship between the benchmark regulatory system and the COS methodology need to be clarified. Failure to

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[115] See Section VI., infra.

[116] See Section II., supra.